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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1939

No. 1039 100

E. R. HAWKE,
Petitioner,
vs.
GUY T. HELVERING, Commissioner of Internal Revenue,
Respondent.

PETITION FOR A WRIT OF CERTIORARI
to the United States Circuit Court of Appeals
for the Ninth Circuit,
and
BRIEF IN SUPPORT THEREOF.

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PETITION FOR A WRIT OF CERTIORARI to the United States Circuit Court of Appeals for the Ninth Circuit.

To the Honorable Charles Evans Hughes, Chief Justice of the United States, and to the Associate Justices of the Supreme Court of the United States:

E. R. HAWKE prays that a Writ of Certiorari issue to review the judgment of the Circuit Court of Appeals for the Ninth Circuit entered in the above-entitled cause on February 26, 1940, affirming the decision of the Board of Tax Appeals in part.

JURISDICTION.

The judgment of the Circuit Court of Appeals affirming the decision of the Board of Tax Appeals in part and reversing it in part, was entered on February 26, 1940. (R. 238.) The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925. (43 Stat. 938, 28 U. S. C. A. Sec. 347 (a).)

STATEMENT OF THE CASE.

The following facts pertinent to the issues here involved were taken from the memorandum opinion of the Board of Tax Appeals, a partial stipulation of facts, and the transcript of the record before the Board.

This appeal involves income taxes for the years 1930 and 1931. Petitioner was first employed by the J. C. Penney Company, a corporation, in 1913 and remained continuously in its employ until May, 1933. From 1919 until he left the employ of the Company in 1933, he was the manager of the Penney Company's store at Modesto, California. Under the corporate set-up of the J. C. Penney Company, each of its stores was individually capitalized under what was known as a classified common stock structure, there being a separate stock classification for each store. The Modesto, California, store was capitalized originally for $6000.00, and, as manager of the store, Petitioner was permitted to, and did, purchase one-third of the classified common stock of said store. Under an oral

contract of employment he received a salary of $75.00 per month and, in addition, received one-third of the profits of the store because of his ownership of one-third of the classified stock of that store. (R. 82-84, 167.) At the end of the calendar year of 1926, he was the owner of sixty (60) shares of the classified common stock No. 97 of the Modesto store, which constituted one-third of the capitalization of said store. (R. 88, 167.) In April, 1927, due to a change in the corporate structure of the J. C. Penney Company, Petitioner's classified common stock in said store was called in by the Company and he received in full payment or exchange therefor, 100 shares of the preferred stock of the Company. (R. 88-89, 97-98, 167.) At the same time he was re-employed by the Company as manager of the Modesto store under a written employment contract, which became effective as of January 1, 1927. (R. 86-97, 167.) Said contract provided among other things:

> "First: The Associate agrees to continue as manager of said store *and to devote his entire time and the best of his ability* to the successful prosecution of his duties as such,
>
> Second: The Company agrees—
>
> (a) Commencing January 1, 1927, to pay to such Associate each year as added compensation, in addition to the regular salary received by him the same fractional portion of the net earnings of said store for which said Associate is manager as he would have been entitled to, had he continued to own and hold said shares of classified common stock which he has delivered to the Company for conversion * * *" (R. 89, 90.)

The contract further provided:

"Fourth: The Company further agrees with the Associate that when by reason of death, disability, or for any other reason, the Associate shall cease * * * to be the manager of such store, the Company will sell to him (or if he ceases to be manager by reason of death, then to his legal representatives or next of kin) at the *then* book value, and he or his legal representatives or next of kin shall have the right to purchase by paying such price, a sufficient number of shares of common stock of the Company, the earnings on which based upon the net earnings of the Company for the last full calendar year, will equal in amount two-thirds of the Associate's proportion (as fixed by paragraph Second hereof) of the average annual net earnings of such store for three full calendar years * * *" (R. 91, 92.)

"Seventh: This and all other manager's conversion contracts are entered into by the Company with the respective Associate upon the Express condition and reservation that if the Board of Directors of the Company deem it necessary or advisable in their discretion, by reason of structural corporate changes, reorganization, dissolution or sale of corporate assets, the Company may call in and terminate all manager's conversion contracts at the end of any calendar year upon paying to each Associate entering into such a contract the amount due to him under paragraph Second hereof and upon permitting each such Associate to exercise his right to purchase the amount of common stock to which he is entitled under paragraph Fourth hereof." (R. 93.)

"Tenth: This contract shall be binding on the parties hereto, their next of kin, legal representa-

tives, successors and assigns, *and it is specifically understood that this is a personal service contract* and that the right to receive added compensation as herein provided and the right to purchase common stock cannot be assigned by the Associate." (R. 94.)

In March, 1929, Petitioner received a letter from the J. C. Penney Company advising him of the intention of the Company to cancel his manager's contract of April, 1927. (R. 99-101.) By letter dated March 18, 1929, Petitioner was advised by the Company that his manager's contract of April, 1927, was cancelled as of December 31, 1928, and that, pursuant to the terms of said contract, he had the right to buy 971 shares of the Company's common stock at a price of $28.00 per share. (R. 101-104, 167-8.) Petitioner exercised his right to buy the stock and purchased 971 shares at a price of $28.00 per share. (R. 168.) (It was stipulated that the purchase was made on or about March 18, 1929, and that the fair market value of said stock at the time of purchase was $367.50 per share.) (R. 163, 168.) Petitioner was re-employed by the J. C. Penney Company as manager of the Modesto, California, store under a written contract dated April 15, 1929, as of January 1, 1929. The new contract did not include any stock purchase rights and the percentage of store earnings to which Petitioner was entitled as compensation was materially reduced. (R. 168.)

In 1930 and 1931 the Petitioner sold certain shares of said 971 shares of stock purchased under the employment contract in 1929. The Respondent after

auditing Petitioner's tax returns for the years 1930 and 1931, assessed a deficiency against Petitioner arising from the sale of said stock and other stock not involved in this appeal. In the determination of the deficiencies, the Respondent used as the cost basis of the said shares to the Petitioner the amount of money which he paid in the acquisition of them. (R. 172.) The Petitioner appealed to the Board of Tax Appeals contending that the proper basis to be used in determining his loss or gain on the sale of said stock was the fair market value of the stock at the date of its acquisition. The Board held that the differential between the price paid by Petitioner for said 971 shares and the fair market value thereof at the date of acquisition was not compensation for services and sustained the cost basis used by Respondent (i. e., the amount of money Petitioner paid for the shares). (R. 181, 182, 183.)

The Court below held "that where there is a 'bona fide' sale from an employer to an employee, at less than market value, * * * Art. 51, Reg. 74, 1928 Rev. Act (Appendix p. ii) cannot transform such purchase * * * into taxable income on the part of the purchaser * * *." (R. 225.) The Court below further held that it was unnecessary for it to decide whether the differential as to the stock in issue constituted additional compensation (R. 233), and sustained the cost basis used by Respondent in determining a deficiency.

QUESTIONS PRESENTED.

The taxpayer in March, 1929, purchased stock of his employer pursuant to an employment contract in evidence, dated April 25, 1927, at a price in money substantially less than fair market value. The price per share which he was to pay for the stock and the number of shares which he was entitled to buy being determinable upon the cancellation of the contract by the company upon the basis of a formula contained therein. The company canceled the contract in March, 1929, and Petitioner exercised his right to buy the stock. The questions are:

1. Did taxpayer receive taxable income in 1929 to the extent of the difference between what he paid his employer in money for 971 shares of stock and the fair market value thereof at the time of purchase, when the right to purchase the stock at "bargain prices" was contained in the contract of employment and the excess value of the stock over and above the amount of money paid was (a) in the nature of compensation for services rendered, or (b) liquidated damages or a penalty imposed on the employer for the cancellation of the contract?

2. Where property is sold by an employer to an employee for an amount of money substantially less than its fair market value and the differential is income to the employee because it is either in the nature of compensation for services rendered, or by way of liquidated damages or the payment by the employer of a penalty imposed for the cancellation of an em-

ployment contract, is it not proper for the employee to use the fair market value of the property at the time of acquisition as his cost basis in determining his profit or loss on the subsequent sale?

STATUTES AND REGULATIONS INVOLVED.

The statutes and regulations involved are set forth in the Appendix, infra, pages i-ii.

REASONS RELIED ON FOR THE ALLOWANCE OF THE WRIT.

1. The decision of the Circuit Court of Appeals for the Ninth Circuit that the "bargain purchase" of 971 shares of stock by Petitioner in 1929 did not result in taxable income to him in that year is in direct conflict with the decision of the Circuit Court of Appeals for the Second Circuit in the case of *Salvage v. Commissioner,* 76 F. (2d) 112, affirmed by this Court in 297 U. S. 106, 56 S. Ct. 375, 80 L. Ed. 511, and is also in conflict with the decision of the Circuit Court of Appeals for the Sixth Circuit in the case of *Robinson v. Commissioner,* 59 F. (2d) 1008.

2. The decision of the said Circuit Court of Appeals as to the proper cost basis to be used by the Petitioner in reckoning his income tax in the years the stock was sold is in conflict with the decision of the Circuit Court of Appeals for the Second Circuit and with the decision of this Court in the case of

Salvage v. Commissioner, supra, and with the decision of the Circuit Court of Appeals for the Sixth Circuit in the case of *Robinson v. Commissioner,* supra.

3. The decision of the said Circuit Court of Appeals, both as to the question of income arising from "bargain purchases" and as to the proper cost basis to be taken by taxpayer, is a decision of important federal questions which are in conflict with applicable decisions of this Court and particularly in conflict with the decision of this Court in the case of *Salvage v. Commissioner,* supra.

4. The decision in the case of *Omaha National Bank v. Commissioner,* 75 F. (2d) 434 (C. C. A. 8th), relied upon and adopted by the Circuit Court of Appeals for the Ninth Circuit in holding that "a bona fide sale from an employer to an employee, at less than market value * * * cannot transform such purchase * * * into taxable income on the part of the purchaser" is in conflict with, and in effect overruled by, the decision of the Circuit Court of Appeals for the Seventh Circuit in the case of *Indianapolis Glove Co. v. U. S.,* 96 F. (2d) 816.

5. The decision of said Circuit Court of Appeals in holding that there was a "bona fide sale" of 971 shares of stock to taxpayer instead of a purchase of stock from which taxable income arose is contrary to the law and the evidence.

6. The question of whether payments made for the cancellation of an employment contract by means of permitting the employee to purchase stock of the em-

ployer at prices substantially below its fair market value constitute taxable income to the employee in the year of the acquisition of the stock to the extent of the differential between the price paid and fair market value is an important question of income taxation not heretofore determined by this Court.

7. The question of whether taxable income results from "bargain purchases" under circumstances similar to the facts in the instant case and the proper cost basis in determining loss or gain on subsequent sales are involved in a number of cases now pending before the Bureau of Internal Revenue and the Courts, and will arise in subsequent cases. Accordingly, to attain uniformity of decision, to obviate confusion on the part of tax authorities and lower Courts, and to serve as a guide in determining what is income in cases involving a situation that is very common and continually recurring, a clear-cut decision by this Court would be of great value.

CONCLUSION.

For the reasons above stated, Petitioner respectfully submits that this Petition should be granted.

Dated, Oakland, California,
May 22, 1940.

E. R. Hawke,
Petitioner.
Alan W. Davidson,
Counsel for Petitioner.